

How to read a prospectus



A prospectus is a formal written document that sets forth a business plan or facts concerning an existing business to assist an investor in making an informed investment decision. It is the official selling circular that must be given to purchasers of new securities registered with the Securities Exchange Commission (SEC). It is part of the much longer Registration Statement filed with the SEC.

A prospectus is important because it contains information concerning the company, its personnel, financial situation, current projects, what it intends to do with your money, and the risks of investing in the company. The Securities Act requires that a prospectus be prepared and issued to all investors interested in purchasing securities in a public offering. The person responsible for distributing the securities must make sure that each investor receives a prospectus.

Unfortunately, reading a prospectus is difficult and takes time. Not everyone read the prospectus and, therefore, may be surprised later when they find out exactly what they have purchased. The suggestions below can help take the mystery out of reading and understanding the prospectus.

The preliminary or “red-herring” prospectus

A preliminary prospectus is clearly marked as such at the top of the title page and in red ink, hence the name, “red-herring” prospectus.

The preliminary prospectus is used to offer securities to an investor before all of the information about those particular securities is known or made available in print.

Although a dealer may not accept any firm commitments on those securities, the preliminary prospectus does allow a dealer to collect intentions to subscribe. While most of the information to be included in the final prospectus is in the preliminary prospectus, the missing sections typically include the offering or issue price and the number of securities to be issued.

The information in the preliminary prospectus is subject to change in response to the comments of the SEC and the Hawaii Office of the Commissioner of Securities, with which the prospectus has been filed for examination.

Step one: Start with the title page

At the top of the front page, in large type, you will find the name of the issuing company and the name of the security being issued. The final prospectus will also list costs and the number of securities offered. Under these details, you will find important information, such as the existence of a secondary market where these securities are bought and sold, and information on the issue of "stock dilution" (described below).

To be certain the securities are registered with state and federal agencies as required by law, call the Business Registration Division, of the Department of Commerce & Consumer Affairs. However, you should also be aware that neither the SEC nor the Hawaii Business Registration Division will make any kind of recommendation or offer any opinion concerning the quality of the securities being offered through the registration procedure. During the registration process, regulators analyze the prospectus only to ensure that it contains necessary information so that the investor has a good understanding of the offering and can evaluate the risks involved.

Step two:

Read the summary section

This section summarizes the information most likely to affect an investor's decision. Read this section with great care and take notes of questions you have. If these questions are not answered to your satisfaction by the time your review of the prospectus is complete, ask your broker.

The summary starts with a review of the main features of the issue and then reviews the company operations. The summary will include the most significant financial data taken from complete financial statements included at the end of the prospectus. This data will typically include figures showing sales, gross income, net income, and earnings per share.

The summary is not intended to replace the text of the prospectus. Rather, it will assist you in understanding what the securities offering represents, and will enable you to ask important questions as you read the essential section of the document.

Step three:

Look at the information in-groups

The following information is included in virtually all prospectuses, though not necessarily in the order presented. Pay close attention to the following areas:

What does the company do?

These various sections of information describe the company and its operations, including how the company was incorporated, a list of its subsidiaries, a description of the real estate it owns, and any legal proceeding in which it may be involved.

Look at the company's customer base and use this information to assess the size and availability of the marketplace for the company's products and/or services. Generally, a large customer base will reduce the company dependency on a few essential clients. For instance, if one essential client or customer finds a new supplier or goes out of business, the effects on the company you are investing in may be disastrous.

Look at the competition. Heavy competition by established companies will make your investment more risky.

Human resources will inform you about the number and types of employees in the company. Watch for a collective bargaining agreement coming to an end, and any history of strikes or poor labor relations.

Thoroughly review the section describing the company's management and their qualifications. The ultimate success or failure of the company depends heavily on the management. Hence, the prospectus devotes a considerable amount of time and space to information concerning its directors and officers. Look at such factors as their experience, education, age, past results with this or previous companies, and the pay and compensation they receive.

What is the company's financial situation?

These sections describe the company's financial picture. If you are not familiar with reading and analyzing this type of data and the accompanying comments by the accountants, you should consider talking to your own accountant or CPA.

The financial statement you will find in the prospectus include the Income Statement, the Cash Flow statement, and the Statement of Changes in Financial Position for the company's recent year of operations, and the Balance Sheet. The prospectus will also include an explanation and analysis by management of previous years' financial results.

The statement of dividends paid during the previous five years may help to assess the company's growth rate and potential. If you are investing for the dividend return, you should pay close attention to the dividend history of the company. Nonpayment of dividends, however, does not indicate a poor financial status, because management may have reinvested the money into the company.

Price-earning ratio (P/E) is a popular way to compare stocks selling at various price levels. The P/E ratio is the current price of a share of stock divided by the earnings per share of the issuing firm for a 12-month period. For example, a stock selling for \$50 a share and earning \$5 a share is said to be selling at a price-earning ratio of 10.

What securities are offered to you?

Do not confuse the success and good performance of the company with the value of the securities now being offered to you as an investor. Carefully examine the characteristics of the securities being offered.

First, read the section describing an investor's rights after purchase of the securities. This section takes on added importance when the securities involve complex units, employee purchase plans, or warrants. If you do not understand how this section affects you, ask your broker for assistance.

Second, read the section explaining how the company intends to use the proceeds of the offering. Use of the proceeds may have a significant effect on the company's results, and may incur additional risks for the company.

Third, review the section covering the issue of "dilution." When a company issues additional shares of a security, it reduces, or "dilutes" the value of earlier shares. This can mean a reduction of voting power if shares are not issued proportionally to the

holdings of existing shareholders. It may be a financial reduction if shares are issued disproportionately and the price at which the new shares are issued is less than the market or book value of the outstanding shares before the new shares were issued.

Fourth, and perhaps most important, are the *risk factors*. You, the investor will take these risks. No one invests to lose money; however, investments always carry some degree of risk. Risk factors may include items common to a given sector of activity (such as the price or availability of raw materials), or items unique to the company (such as a very high debt ratio).

Liquidity

A related factor to pay close attention to is the liquidity of the securities. Liquidity refers to the time required to convert your securities into cash. Some securities, such as stock for which a market exists, can quickly be converted to cash. Other securities, such as limited partnerships, involve a commitment of between five and 10 years. Since there may be no secondary market on which the interest can be sold, conversion into cash may be difficult or impossible before the partnership expires.

Reminders

The information in a prospectus is vital to an investment decision. Before making any investment, be certain you understand what you are investing in and what risks are you taking. This information is readily available in the prospectus. Please take the time to read it.

If you do not understand parts of the prospectus, do not hesitate to ask for assistance from your broker or accountant.

For more information

Department of Commerce & Consumer Affairs

Office of the Commissioner of Securities

1010 Richards Street

Honolulu, Hawaii 96813

(808) 586-2722